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TAGS: EFIN ECON RS PGOV PREL
SUBJECT: GOR GEARS UP PRINTING PRESS TO FINANCE DEFICIT,
PUTTING ADDED PRESSURE ON RESERVES, RUBLE

REF: MOSCOW 00534

Classified By: ECON MC Eric T. Schultz, Reasons 1.4 (b/d).

Summary

¶1. (C) While the GOR continues to debate its revised 2009 budget, two aspects of the budget have become clear in recent weeks: the GOR plans to run a substantial deficit and to finance the deficit with foreign currency in the Reserve Fund (RF), which will be sold to the Central Bank (CBR), which will in turn print rubles to pay for the foreign currency. These decisions reflect a compromise between the two key policy-making Ministries: Finance, which favored a lower budget deficit and Economic Development, which favored borrowing to finance the deficit. Despite CBR claims to the contrary, the deficit is likely to be inflationary and put additional downward pressure on both the ruble and on Russia's foreign exchange reserves. The latter may total no more than $200 billion at the end of the year, complicating Russia's economic decision-making in 2010 should the downturn persist and commodity prices not recover. End Summary.

The Budget Deficit and How the GOR Plans to Finance It

¶2. (SBU) We will address the GOR's long-delayed revised 2009 budget in more detail septel, but there are several aspects of the budget that are already clear, including the GOR's plans to run a substantial deficit this year. Both Finance Minister Kudrin and Presidential Assistant Dvorkovich have made clear in recent public comments that the deficit will be on the order of 8 percent of GDP, or roughly $90-$100 billion. The deficit is the result of a drastic drop in government revenues, more than 40 percent according to Kudrin, along with an increase of $14 billion in government spending aimed at mitigating the social consequences of the economic crisis.

¶3. (C) The delay in announcing the new budget is reportedly the result of internal bickering over how to allocate government expenditures. However, both Kudrin and PM Putin have made clear in recent weeks that the budget's focus will be on social spending, such as increasing unemployment aid and spending on the national projects: public health, housing, agriculture, and education.

¶4. (C) It is also clear that the GOR has chosen to finance

the deficit using the $136 billion RF. The GOR established the RF last year when the Stabilization Fund, where its windfall revenues from oil taxes had been accumulating, was divided into two separate funds. The RF was set up to support the government budget and the other fund, the National Welfare Fund, which has $84 billion, was set up to support the country's pension system. Both funds are included in the GOR's $384 billion in foreign exchange reserves.

¶5. (C) According to GOR officials and private sector experts, the Finance Ministry lost the fight over the deficit but won the fight over how to finance it. According to Kudrin assistant Vadim Grishin, the Ministry had argued for lower expenditures and a more balanced budget. The Ministry of Economic Development (MED), however, had strongly favored deficit spending to stimulate the economy. MED's Deputy Minister for Macroeconomics, Andrei Klepach, told us last month that MED wanted as "big a deficit as possible." The result was a compromise, but one which favored MED's point of view.

¶6. (C) However, Klepach said MED had also favored borrowing internationally to finance the deficit (Russia's domestic bond market being too small), and saving the RF to use in modernizing the economy. Grishin said Kudrin had successfully opposed this, arguing that it made more sense to use the RF now and only borrow later, if the GOR needed to finance deficits in 2010 and 2011, when rates would likely be lower. In that regard, Kudrin announced in his March 10 press conference that as a result of using the RF to cover the deficit, it would be exhausted by the middle of 2011.

CBR: We've Got This

¶7. (C) Despite Kudrin's announcement, it is in fact not clear what the effect on reserves will be of using the RF to finance the deficit. CBR Deputy Chair Ulyukaev created a stir late last month when he told a Russian news service that financing the deficit from the RF would neither decrease those reserves nor be inflationary. Ulyukaev said the Finance Ministry would "sell" foreign currency from the RF to the CBR in exchange for rubles. The Finance Ministry would then use the newly acquired rubles to pay for government expenditures. This would lower the RF's balance but, according to Ulyukaev, have no impact on the CBR's overall reserves because from an accounting perspective, the foreign currency would simply have "migrated" to the CBR's reserves.

¶8. (C) Ulyukaev said the plan would not be inflationary because the CBR would simply reduce lending to banks by a comparable amount, to offset the inflationary effects of the new rubles. Despite the CBR printing up to 3.2 trillion rubles to finance its "purchase" of the RF's foreign exchange, the net effect on money supply would be zero and the plan would not be inflationary.

Analysts: No They Don't

¶9. (C) Local analysts, who noted that the whole point of the deficit spending was to stimulate the economy by increasing demand through government spending, met Ulyukaev's claims with widespread skepticism; reducing the money supply would negate the stimulatory effect and was simply not going to happen. Troika Dialog Chief Economist Evgeny Gavrilenkov said that a liquidity injection of $100 billion would boost money supply by more than 25 percent, potentially increasing inflation and putting pressure on the exchange rate. UralSib's Chief Analyst, Chris Weafer, told us printing rubles would almost certainly drive prices higher and that as

a result the ruble would come under increased pressure.

¶10. (C) Alfa Bank Chief Economist Natalia Orlova told us that the CBR plan would also indirectly put pressure on reserves. Individuals and banks would immediately convert the extra rubles into foreign exchange. Devaluation expectations were still strong among the population, according to Orlova, and pressure on reserves would increase because Russians simply lacked trust in the ruble. She predicted that the GOR plan to cover the deficit would cause the currency to fall 20 percent against the dollar and that reserves, already under pressure from a significant capital account deficit (reftel), could fall to as low as $200 billion by year's end.

Comment

¶11. (C) There are no painless options for the GOR as the economy worsens. For the time being, the GOR appears to have decided in favor of increased spending to spur growth, despite the risk of fanning already high inflation. However, absent an abrupt increase in commodity prices, the GOR will still be faced with a sharply contracting economy -- as much as 10 percent according to some analysts. Moreover, as a result of its decision to run a large deficit, the official inflation rate could surpass 20 percent this year, putting pressure on the ruble and indirect pressure on reserves.

¶12. (C) Orlova's estimate that reserves may be as low as $200 billion by the end of the year is entirely plausible. This is dangerously close to the rating agencies' rumored requirement that the GOR keep at least $170-$180 billion in reserves in order to maintain its investment grade rating -- critical should Russia have to borrow next year to finance another substantial deficit. As bad as this year looks for Russia, 2010 will be significantly worse absent a rise in commodity prices. The GOR will want to continue to mitigate social tensions through deficit spending but, unable to fund the deficit out of its own resources, may find itself constrained by the need to borrow internationally.

BEYRLE